

Audit



Report

OFFICE OF THE INSPECTOR GENERAL

CONTRACTED SERVICES FOR THE
MEDIUM ALTITUDE ENDURANCE UNMANNED
AERIAL VEHICLE JOINT PROJECT OFFICE

Report No. 96-203

July 31, 1996

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Department of Defense

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Acronyms

| | |
|--------|-------------------------------------|
| DCMC | Defense Contract Management Command |
| FAR | Federal Acquisition Regulation |
| FISC | Fleet Industrial Supply Center |
| NAVAIR | Naval Air Systems Command |
| NSWC | Naval Surface Warfare Center |



**INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-2884**



July 31, 1996

**MEMORANDUM FOR ASSISTANT SECRETARY OF THE NAVY (FINANCIAL
MANAGEMENT AND COMPTROLLER)**

**SUBJECT: Audit Report on Contracted Services for the Medium Altitude Endurance
Unmanned Aerial Vehicle Joint Project Office (Report No. 96-203)**

We are providing this audit report for your information and use. This report is the second of two reports discussing contract issues specified in a complaint to the Defense Hotline. Management comments on a draft of this report were considered in preparing the final report.

Comments on a draft of this report conformed to the requirements of DoD Directive 7650.3 and left no unresolved issues. Therefore, no additional comments are required.

We appreciate the courtesies extended to the audit staff. Questions on the audit should be directed to Mr. Terry L. McKinney, Audit Program Director, at (703) 604-9288 (DSN 664-9288) or Mr. Henry F. Kleinknecht, Audit Project Manager, at (703) 604-9324 (DSN 664-9324). See Appendix G for the report distribution. The audit team members are listed inside the back cover.

David Steensma

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Office of the Inspector General, DoD

Report No. 96-203
(Project No. 6CF-8001)

July 31, 1996

Contracted Services for the Medium Altitude Endurance Unmanned Aerial Vehicle Joint Project Office

Executive Summary

Introduction. This report is the second of two reports that discuss a complaint to the Defense Hotline that work was being improperly directed by a program manager to a Section 8(a) contractor on a sole-source basis and that labor costs charged to DoD contracts were questionable. The first report discusses sole-source Section 8(a) contracts awarded by the Small Business Administration for the Naval Air Systems Command. This report discusses the use by the Navy Medium Altitude Endurance Unmanned Aerial Vehicle Joint Project Office (the Joint Project Office) of intra-agency contracting with other Navy organizations to award sole-source orders for contracted services to Battlespace, Incorporated (Battlespace). The report also discusses questionable labor costs that Battlespace charged to DoD contracts.

Battlespace, or previously, the person who subsequently became the president of Battlespace, has provided continuous support to the Joint Project Office since October 1992 as a subcontractor or consultant on five prime contracts. The prime contracts were awarded by three Navy organizations and administered by five DoD organizations. Three of the contracts are time-and-materials contracts, one is a firm-fixed-price contract, and the fifth is a cost-plus-fixed-fee contract. The periods of performance on the five contracts overlap, and the total subcontract amount is about \$6.4 million.

Audit Objectives. The primary audit objective was to review the award and administration of sole-source orders to Battlespace for support to the Joint Project Office. Specifically, we determined whether procedures were effective to prevent a high-risk mix of sole-source time-and-materials, firm-fixed-price, and cost-plus-fixed-fee contracts from being awarded by different contracting offices to the same contractor for similar work. We also determined the allowability, reasonableness, and allocability of labor costs charged to the contracts. We did not review the management control program at the Naval Air Systems Command because the program was reviewed during the audit that resulted in our first report.

Audit Results. We did not substantiate the complaint that Battlespace influenced the Joint Project Office to improperly award sole-source orders to Battlespace or that Battlespace charged unallowable labor costs to DoD contracts. Details of the allegations are discussed in Appendix C. The Joint Project Office did use intra-agency contracting with other Navy organizations that ultimately resulted in the award of sole-source orders valued at more than \$1 million, with Battlespace as a subcontractor, without appropriate reviews by the Naval Air Systems Command Contracts Division. As a result, Battlespace was awarded a high-risk mix of overlapping labor contracts, and Battlespace charged questionable labor costs totaling \$379,257 to DoD contracts for calendar years 1993 and 1994. Implementing the recommendations would provide

better control over the use of high-risk overlapping labor contracts and should produce future monetary benefits. However, we could not quantify the benefits because the amount will depend on future contract decisions. See Part I for the details of our review. See Appendix E for a summary of potential benefits resulting from the audit.

Summary of Recommendations. We recommend that the Program Executive Officer, Cruise Missiles Project and the Unmanned Aerial Vehicles Joint Project, issue a policy memorandum to project offices and provide appropriate training to project office personnel relating to intra-agency contracting. The policy memorandum and training should emphasize the need to follow the Naval Air Systems Command requirement to forward funding documents and sole-source justifications to the cognizant Naval Air Systems Command Contracts Division for intra-agency contracts with Navy organizations that ultimately result in sole-source contracts or orders with values greater than \$1 million. We also recommend that the Commander, Naval Air Systems Command, clarify guidance in Naval Air Systems Command Instruction 7300.8C to ensure the term "noncompetitive contracts" also includes noncompetitive orders and instruct the contracting officer for time-and-materials contract N00019-94-D-0129 to renegotiate fixed-hourly rates for Option Year II to a rate that reflects the actual hours worked under prior contracts.

Management Comments. Navy comments were fully responsive. The Navy agreed to provide training to program office, contracting, and business and financial personnel on intra-agency contracting. The Navy also agreed to clarify guidance on intra-agency contracting to include noncompetitive orders, to review the fixed hourly rates on contract N00019-94-0129, and to determine whether a renegotiation of the rates was appropriate for Option Year II. See Part I for a complete discussion of the management comments and Part III for the complete text of management comments.

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Part I - Audit Results

Introduction

This report resulted from a complaint to the Defense Hotline and is the second of two reports related to that complaint. This report discusses the use by the Navy's Joint Project Office for the Medium Altitude Endurance Unmanned Aerial Vehicle of intra-agency contracting with other Navy organizations to place sole-source (noncompetitive) orders for contracted services. The report also discusses questionable labor costs charged to DoD contracts in support of the Joint Project Office.

The first report, Inspector General, DoD, Report No. 96-059, "Complaint to the Defense Hotline on Sole-Source Section 8(a) Contracts at the Naval Air Systems Command," January 16, 1996, discusses sole-source Section 8(a) contracts awarded by the Small Business Administration for the Naval Air Systems Command (NAVAIR).

Audit Background

Program History. The Joint Staff determined that current national, theater, and tactical intelligence collection assets were insufficient to provide urgently needed information on mobile targets. In addition, no unmanned aerial vehicle system existed that could provide all-weather coverage of worldwide targets for longer than 12 hours. As a result, on July 12, 1993, the Under Secretary of Defense (Acquisition)* requested that the Navy Program Executive Office for the Cruise Missiles Project and the Unmanned Aerial Vehicles Joint Project Office implement and manage a new unmanned aerial vehicle program. The program would be for a quick-reaction, endurance class unmanned aerial vehicle. That Navy Program Executive Office created the Medium Altitude Endurance Unmanned Aerial Vehicle Joint Project Office (the Joint Project Office) to contract for and demonstrate a deployable system suitable for long-range missions.

Contracted Services to Support the Joint Project Office. The Joint Project Office initially used the person who later became the president of Battlespace, Incorporated (Battlespace), as a consultant as early as October 1992. During calendar years 1993 and 1994, the person was billing the Joint Project Office on one contract as a consultant and on another contract as the president of Battlespace. As of March 1996, Battlespace had been supporting the Joint Project Office as a subcontractor on prime contracts awarded by NAVAIR, Arlington, Virginia; the Naval Surface Warfare Center (NSWC), Dahlgren, Virginia; and the Fleet and Industrial Supply Center (FISC), Charleston, South Carolina.

*Now, Under Secretary of Defense for Acquisition and Technology.

Contracted services from Battlespace were procured through the use of delivery orders on time-and-materials, firm-fixed-price, and cost-plus-fixed-fee contracts. The contracts are administered by various Defense Contract Management Command (DCMC) and FISC offices.

Table 1 shows the contract numbers, delivery order numbers, contract types, periods of performance, Battlespace subcontract amounts, and the offices that awarded and administered the contracts.

Table 1. Contracts That the Joint Project Office Used to Procure Services From Battlespace

| <u>Prime Contract Number (Contract Type)</u> | <u>Delivery Order</u> | <u>Period of Performance</u> | <u>Battlespace, Inc. Subcontract Amount</u> | <u>Contract Issued/ Administered</u> |
|--|-----------------------|-------------------------------|---|--|
| N60921-89-D-A301 (Time-and-materials) | 0004 | Oct. 1, 1992 - Mar. 31, 1993 | \$ 72,703* | NSWC Dahlgren/ DCMC Springfield |
| | 0005 | May 10, 1993 - Apr. 30, 1994 | 144,968* | |
| N00019-92-D-0004 (Time-and-materials) | 0009 | May 3, 1993 - Sep. 30, 1993 | 64,409 | NAVAIR/ DCMC Baltimore |
| | 0013 | Oct. 1, 1993 - May 15, 1994 | 343,313 | |
| N00612-92-D-0018 (Firm-fixed-price) | 0029 | Mar. 18, 1994 - Sep. 30, 1994 | 688,135 | FISC Charleston/ FISC Philadelphia |
| | 0041 | Nov. 15, 1994 - Feb. 17, 1995 | 209,990 | |
| | 0043 | Feb. 1, 1995 - Jan. 31, 1996 | 871,079 | |
| N00019-94-D-0129 (Time-and-materials) | 0001 | May 1, 1994 - Sep. 30, 1994 | 316,932 | NAVAIR/ DCMC Baltimore |
| | 0002 | Oct. 1, 1994 - Apr. 30, 1995 | 524,893 | |
| | 0003 | May 1, 1995 - Sep. 30, 1995 | 376,458 | |
| | 0004 | Oct. 1, 1995 - Apr. 30, 1996 | 520,296 | |
| | | May 1, 1996 - Apr. 30, 1997 | 865,024 | |
| N00178-95-C-3043 (Cost-plus-fixed-fee) | None | Aug. 1, 1995 - Jan. 31, 1998 | <u>1,402,213</u> | NSWC Dahlgren/ DCMC Van Nuys |
| Total | | | \$6,400,413 | |

*Work was performed by the president of Battlespace as a consultant.

Services Provided by Battlespace. Battlespace was tasked to support the Joint Project Office in various phases of program management.

Contract N60921-89-D-A301. Battlespace was tasked to conduct research and studies to develop a systems engineering plan that established a joint battlefield and force architecture and concept of operations for the unmanned aerial vehicle system variants.

Contract N00019-92-D-0004. Battlespace was tasked to develop a program execution plan that included work plan input for systems engineering, training and logistics, concept of operations, multimedia demonstration, and test and demonstration.

Audit Results

Contract N00612-92-D-0018. Battlespace was initially tasked to develop a core group of factory-trained, subject matter experts for the tactical endurance unmanned aerial vehicle. The core group would then develop the training materials and provide follow-on training for the remaining personnel or for new or replacement personnel. Other tasks listed on the contract to be done later required Battlespace to review previously developed training materials and to develop course materials to support second-phase configuration.

Contract N00019-94-D-0129. Battlespace was tasked to provide project support in the areas of planning and monitoring, engineering design, system test, operational test and evaluation, concept of operations development, training and logistics analysis, systems development, and program development.

Contract N00178-95-C-3043. Battlespace was tasked to provide system engineering support for the active aperture antenna for the medium altitude endurance unmanned aerial vehicle.

Audit Objectives

The primary audit objective was to review the award and administration of sole-source orders to Battlespace for support to the Joint Project Office. Specifically, we determined whether procedures were effective to prevent a high-risk mix of sole-source time-and-materials, firm-fixed-price, and cost-plus-fixed-fee contracts from being awarded by different contracting offices to the same contractor for similar work. We also determined the allowability, reasonableness, and allocability of labor costs charged to the contracts. We did not review the management control program at NAVAIR because the program was reviewed during the earlier audit and discussed in Report No. 96-059. See Appendix A for a discussion of the audit scope and methodology. Appendix B summarizes prior coverage related to the audit objectives. Appendix C discusses the unsubstantiated complaint to the Defense Hotline.

Intra-Agency Contracting by the Joint Project Office

The Joint Project Office for the Medium Altitude Endurance Unmanned Aerial Vehicle used intra-agency contracting with other Navy organizations to place sole-source orders greater than \$1 million, with Battlespace as a subcontractor, without appropriate reviews by the NAVAIR contracts division. The intra-agency contracting orders were not reviewed by the cognizant NAVAIR contracts division because the Joint Project Office business manager did not follow a requirement to forward funding documents and sole-source justifications to the contracts division for review. As a result, Battlespace was awarded a high-risk mix of overlapping labor contracts (time-and-materials, firm-fixed-price, and cost-plus-fixed-fee), and Battlespace charged DoD contracts questionable labor costs totaling \$379,257 for calendar years 1993 and 1994.

Contracting for Supplies and Services

Dedicated NAVAIR Contracting Support for the Joint Project Office. NAVAIR has an operating agreement with Naval Aviation Program Executive Officers that formalizes the support and services NAVAIR provided to the Joint Project Office. Programs managed by the Program Executive Officer for the Cruise Missiles Project and the Unmanned Aerial Vehicles Joint Project receive the same degree of contracting support as do NAVAIR programs under NAVAIR management. NAVAIR supplies dedicated contracting officers and supporting staff to perform contracting functions in support of the Joint Project Office.

Congressional Guidance on Ordering Within the Same Agency or Another Agency. United States Code, title 31, section 1535 (31 U.S.C. 1535), "Agency Agreements," generally permits orders for goods and services to be placed with a major organizational unit either within the same agency or at another agency, so long as the orders are in the best interest of the Government. Congress directed that the Secretary of Defense prescribe regulations for purchases made through other agencies (also known as Economy Act orders). The regulations require such purchases be approved in advance by a DoD contracting officer with authority to contract for the goods or services. In addition, purchases must be made under a preexisting contract of the servicing agency for the same or similar goods or services.

Federal Regulation on Economy Act Orders. The Federal Acquisition Regulation (FAR), subpart 17.5, "Interagency Acquisitions Under the Economy Act," provides policies and procedures applicable to interagency acquisitions under the Economy Act. The FAR states that the Economy Act also provides

Intra-Agency Contracting by the Joint Project Office

authority for placement of orders between major organizational units within an agency, and that agency regulations should specify procedures for such intra-agency transactions.

NAVAIR Guidance on Ordering Supplies and Services From Other Navy Organizations. NAVAIR Instruction 7300.8C, "Naval Air Systems Command Headquarters Responsibilities and Procedures for Funding Field Organizations," May 20, 1994, provides responsibilities and procedures for ordering supplies and services from other Navy organizations. The Instruction requires that orders for supplies or services through other Navy organizations that result in sole-source contracts greater than \$1 million be reviewed by the cognizant NAVAIR contracts division.

Funding documents (either direct cite or reimbursable) to other Navy activities (including NAVAIR field activities) which will ultimately result in noncompetitive contracts greater than one million dollars must be forwarded to the cognizant Contracts Division for review. The funding documents and sole source justification will be submitted to the Contracts Division prior to forwarding to the Comptroller

Contracted Services for the Joint Project Office from Battlespace

Continuous Support from Battlespace. As shown in Table 1, Battlespace or the president of Battlespace as a consultant for a company with his name has provided continuous support to the Joint Project Office since October 1992. Battlespace support to the Joint Project Office was provided on contracts awarded by the cognizant NAVAIR contracting officer designated to support the Joint Project Office and by contracting officers at NSWC Dahlgren and FISC Charleston. Representatives from the Joint Project Office stated that they used intra-agency contracting to place sole-source orders with Battlespace primarily because the NAVAIR contract was "lagging or not ready to go."

Intra-Agency Contracting to Order Contracted Services Through Other Navy Organizations. The Joint Project Office is permitted to use intra-agency contracting to place orders for contracted services through other Navy organizations when it is in the best interest of the Government. The orders generally are placed on an existing contract at the servicing Navy organization and result in sole-source (noncompetitive) orders.

Intra-Agency Contracting by the Joint Project Office

Table 2 shows the orders issued to other Navy organizations that resulted in sole-source orders awarded to either the president of Battlespace as a consultant or Battlespace as a subcontractor.

Table 2. Intra-Agency Orders Issued by the Joint Project Office to Other Navy Organizations that Resulted in Sole-Source Orders to Battlespace

| <u>Document Number</u> | <u>Date Authorized</u> | <u>Order Issued To</u> | <u>Estimated Amount</u> |
|------------------------|------------------------|------------------------|-------------------------|
| N0001992WX8P54D | September 10, 1992 | NSWC Dahlgren | \$1,215,000 |
| N0001994RC8PCZD | February 1, 1994 | FISC Charleston | 1,000,000 |
| N0002495RC10469 | October 18, 1994 | FISC Charleston | 210,000 |
| N0001995RC8PAJD | November 18, 1994 | FISC Charleston | 1,330,614 |
| N0001995WX8PBDP | January 13, 1995 | NSWC Dahlgren | <u>3,800,000</u> |
| Total | | | \$7,555,614 |

Review by the Cognizant NAVAIR Contracts Division

NAVAIR Policy. NAVAIR Instruction 7300.8C requires that when intra-agency contracting is used to place orders through other Navy organizations, and those orders ultimately result in noncompetitive contracts greater than \$1 million, funding documents and the sole-source justification must be forwarded to the cognizant contracts division for review. Although the guidance uses the term "noncompetitive contracts," noncompetitive orders on existing contracts at the servicing activity are basically the same thing. The Commander, Naval Air Systems Command, should clarify the guidance on intra-agency contracting to ensure that use of the term "noncompetitive contracts" also includes noncompetitive orders on existing contracts. Unless noncompetitive orders are included in the guidance, NAVAIR contracting officers will not be aware of other contracts awarded by Navy organizations to support program offices that are also being supported on contracts issued by NAVAIR.

Responsibility of the Joint Project Office. Three of the five orders shown in Table 2 resulted in sole-source orders greater than \$1 million, with a fourth order at exactly \$1 million. However, the business manager for the Joint Project Office did not follow the requirement to forward funding documents and

Intra-Agency Contracting by the Joint Project Office

sole-source justifications to the cognizant NAVAIR contracts division for review prior to funds being transferred. Consequently, the NAVAIR contracting officer responsible for supporting the Joint Project Office was unaware of the other contracts and the high-risk mix of contract types awarded to Battlespace by Navy organizations to support the Joint Project Office.

The Program Executive Officer for the Cruise Missiles Project and the Unmanned Aerial Vehicles Joint Project Office should issue a policy memorandum to project offices and provide appropriate training on intra-agency contracting to project office personnel. The policy memorandum and training should emphasize the NAVAIR requirement and need to forward funding documents and sole-source justifications to the cognizant NAVAIR Contracts Division before issuing orders to other Navy organizations that ultimately result in sole-source contracts or orders greater than \$1 million.

Results of Using Various Navy Organizations to Contract With Battlespace

Guidance on Types of Contracts. Under a time-and-materials contract, the contractor charges the Government for time spent in performance at fixed (negotiated) labor rates and for materials used. FAR 16.601, "Time-and-Materials Contracts," states that a time-and-materials contract provides no positive profit incentive to the contractor for cost control or labor efficiency. Therefore, appropriate Government surveillance of contractor performance is required on such contracts to give reasonable assurance that efficient methods and effective cost controls are being used.

The Defense Contract Audit Agency Contract Audit Manual states that contractors with a mix of cost-type (including time-and-materials) and fixed-price type contracts have a greater motivation to charge costs allocable to fixed-price work to cost-reimbursable contracts.

A contractor whose contracts are all fixed-price or all cost-type would have relatively little incentive to mischarge between contracts. On the other hand, a contractor with a mix of cost-type and fixed-price/commercial work would generally have a much greater motivation to charge effort allocable to fixed-price or commercial work to a cost-reimbursable contract.

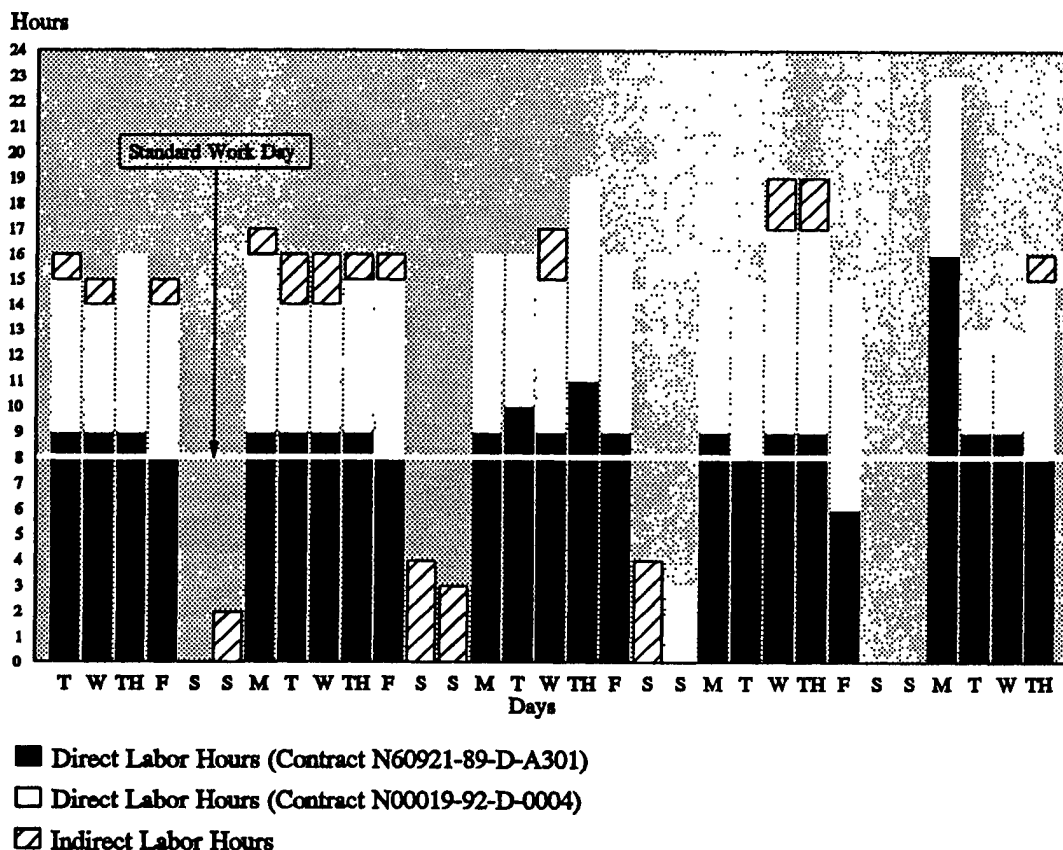
Overlapping Time-and-Materials Contracts. As shown in Table 1, the periods of performance for time-and-materials contracts N60921-89-D-A301 and N00019-92-D-0004 overlapped. The contracts were awarded and administered by different Navy organizations, making Government surveillance of the time the president of Battlespace was charging to both contracts difficult.

In March 1994, the president of Battlespace charged 362 direct hours to the two time-and-materials contracts to support the Joint Project Office, basically charging full time (8-hour days) to both contracts. When we questioned the

Intra-Agency Contracting by the Joint Project Office

president of Battlespace about the number of hours worked, the president, a retired Navy Captain, stated that we "obviously had never been in the military." The president of Battlespace had previously stated to DoD officials that he kept very precise records regarding the tasks he performed on both contracts in order to charge his time appropriately. When further questioned about the 23 hours worked on March 28, 1994, the president of Battlespace checked a personal time log and stated that the 23 hours billed for that day were incorrect and that only 16 hours had been worked. The president of Battlespace further stated that an adjustment would be made for the hours incorrectly billed and that hours billed on all other days were accurate.

The following figure shows the 362 direct hours (hours directly billed to the contracts) billed and 30 indirect hours (hours not directly billed but that form the basis for indirect rates such as overhead and general and administrative expense rates) worked by the president of Battlespace during March 1994.



Direct Labor Hours Billed and Indirect Hours Worked by the President of Battlespace on Time-and-Materials Contracts During March 1994

Overlapping Firm-Fixed-Price Contracts and Time-and-Materials Contracts. Table 1 shows that the periods of performance on the firm-fixed-price delivery orders on contract N00612-92-D-0018 overlap the period of performance on the time-and-materials delivery orders on the other contracts. Battlespace employees charged both the time-and-materials delivery orders and the firm-fixed-price delivery orders during the same periods. The two completed firm-fixed-price delivery orders had significant underruns that resulted in additional profits of about \$169,237. Battlespace earned a total profit on the two delivery orders of about \$216,898 versus the negotiated profit of \$47,661, or about 3.6 times the fair and reasonable profit negotiated for the delivery order. We were unable to determine the specific reasons why Battlespace was able to underrun the firm-fixed-price delivery orders. A representative for the Army stated that Army personnel assisted Battlespace on one of the delivery orders, which may have reduced the number of hours of labor Battlespace expended to deliver the services.

Firm-fixed-price delivery order 0029 was negotiated based on 11,722 labor hours at a total price of \$657,667, which included a profit of 8 percent. Battlespace was able to complete the work using 9,931 hours at an estimated cost of about \$485,554, resulting in a profit of about \$172,113, or 35 percent.

We were unable to determine the proposed hours for firm-fixed-price delivery order 0041, but the negotiated total labor price was \$155,000, and the negotiated profit was again 8 percent. Battlespace was able to complete the work at an estimated cost of about \$110,215, resulting in a profit of about \$44,785, or 41 percent.

The firm-fixed-price delivery orders were performed concurrent with the time-and-materials delivery orders, creating the potential for work allocable to the firm-fixed-price delivery orders to be charged to the cost-type time-and-materials contracts.

Differences Between Proposed/Negotiated and Actual Battlespace Labor Hours and Costs for 1993 and 1994. Battlespace billed the Navy for significantly more direct labor hours for key employees than the direct hours proposed for those individuals on NAVAIR time-and-materials contract N00019-94-D-0129. An accurate estimate of direct and indirect labor hours is necessary during contract negotiations to establish fair and reasonable labor rates on time-and-materials contracts.

NAVAIR time-and-materials contract N00019-94-D-0129 is Battlespace's largest contract. The contract has a base year and 2 option years. The maximum Battlespace labor price for the 3 years is about \$3.5 million. The period of performance for the contract and its option years is May 1, 1994, through April 30, 1997.

NAVAIR negotiated fixed hourly rates for Battlespace that included wages, overhead, general and administrative expenses, and profit. The basis for the fixed hourly rates for key Battlespace employees is shown in Appendix D. The Battlespace employees were salaried employees. Salaried employees are paid a salary to provide a service, and that salary is based on providing that service in whatever time is required. For example, the appendix shows that the annual salary that was determined reasonable for the program manager (the president of Battlespace) was \$100,000. The proposal for program manager was based on a 2,080-hour work year, with 1,042 hours as direct time and the remaining 1,038 hours as indirect time. The costs for the indirect hours were built into the fixed hourly rates. Consequently, once the program manager billed 1,042 direct hours to Navy contracts, Battlespace had recovered the annual costs for that employee, or the annual salary for that employee that the NAVAIR contracting officer had determined was fair and reasonable. After that, hours charged for that employee represented either extra profit for Battlespace or additional salary for the employee.

Intra-Agency Contracting by the Joint Project Office

Table 3 shows that key Battlespace employees billed significantly more direct labor hours than the number of labor hours proposed or negotiated and used to calculate the fixed hourly rates for the NAVAIR time-and-materials contract. The resulting increased labor costs are, therefore, questionable.

Table 3. Comparison of Proposed/Negotiated Labor Hours and Costs for Contract N00019-94-D-0129 with Actual Labor Hours and Costs on All Contracts for Calendar Years 1993 and 1994

| Title or Labor Category | Proposed/Negotiated | | | Actuals | | <u>Questionable</u> <u>Hours</u> <u>Costs</u> | |
|--------------------------------|--|-----------------------------|-----------------------------|---------------------------|----------------------------|--|---------------|
| | Annual Direct Hours ¹ | Hourly Rate ¹ | Estimated Annual Cost | Direct Hours Billed | Cost of Billed Hours | | |
| CY ² 1993 | | | | | | | |
| President | 1,042 | \$102.44 | \$106,742 | 2,924 | \$174,749 | 1,882 | \$ 68,007 |
| Chairman of the Board | 1,042 | 102.44 | 106,742 | 2,457 | 162,208 | <u>1,415</u> | <u>55,466</u> |
| Total CY 1993 | | | | | | 3,297 | \$123,473 |
| CY 1994 | | | | | | | |
| President | 1,042 | \$102.44 | \$106,742 | 2,424 | \$219,562 | 1,382 | \$112,820 |
| Chairman of the Board | 1,042 | 102.44 | 106,742 | 1,730 | 170,739 | 688 | 63,997 |
| Operational Systems Analyst | 1,117 | 79.38 | 88,667 | 1,859 | 114,148 | 742 | 25,481 |
| Test Engineer II | 1,117 | 79.38 | 88,667 | 2,115 | 133,197 | 998 | 44,530 |
| Junior Program Analyst | 1,326 | 30.72 | 40,735 | 1,578 | 49,691 | <u>252</u> | <u>8,956</u> |
| Total CY 1994 | | | | | | 4,062 | \$255,784 |
| Total CYs 1993 and 1994 | | | | | | | \$379,257 |

¹The basis for direct hours and hourly rates were proposed/negotiated amounts in time-and-materials contract N00019-94-D-0129.

²Calendar year.

The questionable labor costs are a result of the mix of time-and-materials and fixed-price contracts. Had cost-plus-fixed-fee type contracts been used instead of the time-and-materials and firm-fixed-price contracts, only the negotiated annual salary costs would have been allowable, no matter how many hours the Battlespace employees worked.

We discussed questionable labor hours and costs with the cognizant Defense Contract Audit Agency branch office and determined that the contracts probably were not defectively priced. Pricing was not defective because the contractor may not have known the number of direct hours that would be worked when cost proposals were submitted. However, because significant differences existed between the annual direct hours used to calculate the fixed hourly rates on NAVAIR time-and-materials contract N00019-94-D-0129 and the actual annual direct hours charged by Battlespace employees, the NAVAIR contracting officer needs to renegotiate the fixed-hourly rates for Option Year II. The period of performance for Option Year II is May 1, 1996, through April 30, 1997.

Recommendations and Management Comments

1. We recommend that the Program Executive Officer, Cruise Missiles Project and the Unmanned Aerial Vehicles Joint Project, issue a policy memorandum to project offices and provide appropriate training to project office personnel relating to intra-agency contracting. The policy memorandum and training should emphasize the need to forward funding documents and sole-source justifications to the cognizant Naval Air Systems Command contracts division for orders issued through other Navy organizations that ultimately result in sole-source contracts or orders greater than \$1 million.

Management Comments. The Navy concurred with the recommendation and stated that the Naval Air Systems Command has policy on procedures for intra-agency contracting. Since "orders" are not specified in Instruction 7300.8C, a memorandum will be issued clarifying that orders are included within the meaning of "contracts" as the term is used in Instruction 7300.8C. The Navy also stated that training on intra-agency contracting will be provided to program office, contracting, and business and financial personnel. The training will stress the importance and necessity of complying with policy instructions.

2. We recommend that the Commander, Naval Air Systems Command:

a. Clarify the guidance on intra-agency contracting to ensure that "noncompetitive contracts" also includes noncompetitive orders on existing contracts.

Intra-Agency Contracting by the Joint Project Office

Management Comments. The Navy concurred, stating that guidance on intra-agency contracting pertains to non-competitive orders placed on existing requirements contracts or basic ordering agreements. The memorandum, issued in response to Recommendation 1., will clarify the issue.

b. Instruct the contracting officer for contract N00019-94-D-0129 to renegotiate fixed-hourly rates for Option Year II to a rate that reflects the actual hours worked under prior contracts.

Management Comments. The Navy concurred, stating that the contracting officer will review the rates and hours incurred during the first option year in order to determine whether an adjustment to the negotiated rates for the second option year is warranted. The anticipated completion date is August 31, 1996.

Part II - Additional Information

Appendix A. Scope and Methodology

Scope

Audit Scope. We reviewed subcontracts and delivery orders awarded to Battlespace or the president of Battlespace as a consultant from October 1992 through September 1995 as shown in Table 1. We reviewed labor charges by contractor employees on each delivery order and reviewed labor charges by the Battlespace Chairman of the Board while that person worked at ITT Defense and Electronics.

Audit Period, Standards, and Locations. We performed this economy and efficiency audit from October 1995 through March 1996 in accordance with auditing standards issued by the Comptroller General of the United States, as implemented by the Inspector General, DoD. Our scope was limited in that we did not include tests of management controls. Appendix F lists the organizations visited or contacted.

Methodology

Review of Contractor Labor Charges. We reviewed contractor time logs and monthly billings for each delivery order to determine hours and amounts charged to DoD contracts by Battlespace employees for calendar years 1993 and 1994. We interviewed the NAVAIR Unmanned Aerial Vehicles contracting officer, the Joint Project Office program manager and business manager, and Battlespace representatives.

Use of Computer-Processed Data. We did not use computer-processed data or statistical sampling procedures for this audit.

Appendix B. Summary of Prior Audits and Other Reviews

This appendix includes a summary of the prior report relating to a complaint to the Defense Hotline and summaries of other prior reports relating to inter-agency contracting.

Inspector General, DoD

Report No. 96-059. Inspector General, DoD, Report No. 96-059, "Complaint to the Defense Hotline on Sole-Source Section 8(a) Contracts at the Naval Air Systems Command," January 16, 1996, is the first report we issued on the complaint to the Defense Hotline discussed in this report. Report No. 96-059 states that NAVAIR was not recommending competition for Section 8(a) contracts with anticipated award prices greater than \$3 million.

The report recommends that the Commander, NAVAIR, require contracting officers and the small business representative to base competition decisions for Section 8(a) procurements on an anticipated contract award price of 95 percent of the maximum contract amount when determining whether the anticipated award price was greater than \$3 million. Also, NAVAIR had not fully implemented its management control program.

NAVAIR concurred with the intent of the recommendation to require contracting officers and the small business representative to recommend competition for Section 8(a) contracts with anticipated award prices greater than \$3 million and to fully implement a management control program. NAVAIR nonconcurred with the recommendation to base Section 8(a) competitive threshold decisions on a percentage of the maximum contract amount determined by historic contract funding levels. NAVAIR stated it uses 100 percent of the "good faith estimate of the total value" to determine the anticipated contract award price. NAVAIR also nonconcurred with the potential monetary benefits, stating that the amended guidance from the Small Business Administration was in effect before the draft audit report was received and that NAVAIR was in compliance with the guidance. After meeting with NAVAIR and clarifying its response to the report, we accepted NAVAIR's response to the recommendations.

Report No. 96-018. Inspector General, DoD, Report No. 96-018, "DoD Use of Economy Act Orders Issued to a Central Intelligence Agency Component," October 27, 1995, states that DoD has no assurance that Economy Act orders placed on the National Photographic Interpretation Center contracts represent a "best value" for DoD.

The report recommends that the DoD Components stop issuing Economy Act orders on the 1995 contract with the National Photographic Interpretation Center; cancel any unfilled orders related to the 1995 contract; and review the

Appendix B. Summary of Prior Audits and Other Reviews

performance of and take appropriate actions against DoD officials who exceeded their authority. Also, the report recommends that DoD establish aggressive milestones for completion of a DoD instruction that incorporates the requirements of the February 8, 1994, Secretary of Defense memorandum, "Use of Orders Under the Economy Act." The report also recommends that a refund be obtained from the National Photographic Interpretation Center in an amount equal to the value of computer equipment received as a rebate for the Economy Act orders and the amount of the discount for prompt payment received by the Center.

The DoD Components generally concurred with the recommendations. They stated they had initiated action to stop issuing Economy Act orders and to cancel unfilled Economy Act orders. The Army, Navy, and Defense Mapping Agency did not agree that the orders placed directly with Sun Microsystems were subject to the provisions of the Economy Act, but have taken corrective action to eliminate unauthorized Economy Act transfer and contract offloading.

Report No. 94-135. Inspector General, DoD, Report No. 94-135, "Procurements by the Non-Acoustic Anti-Submarine Warfare Program Through the Environmental Technologies Laboratory," June 14, 1994, states that \$18.6 million of the \$18.9 million Economy Act orders let through the Non-Acoustic Anti-Submarine Warfare Program Office to the Environmental Technologies Laboratory was not reviewed and approved by a DoD contracting officer.

The report recommends that the Director, Washington Headquarters Services, require a justification from a DoD contracting officer that the Air Force District of Washington 1100th National Capital Region Support Group recover fees totaling \$1.2 million and that the Department of Commerce, the Environmental Technologies Laboratory, and the Tennessee Valley Authority assess the Non-Acoustic Anti-Submarine Warfare Program. The Director, Administration and Management, Office of the Secretary of the Defense, partially concurred with the recommendations directed to the Washington Headquarters Services. The Air Force concurred with the recommendations.

The National Oceanic and Atmospheric Administration Environmental Technologies Lab stated that the Department of Commerce had not agreed with the audit report and declined to return the \$1.2 million in fees, stating the funds had been spent properly and that no funds remained to be transferred to DoD. On October 14, 1994, the Director, Administration and Management, Office of the Secretary of Defense, issued a memorandum to clarify the proper use of Economy Act orders and to require justification for any amendment greater than 20 percent of the basic agreement.

Report No. 94-088. Inspector General, DoD, Report No. 94-008, "DoD Procurements through the Tennessee Valley Authority Technology Brokering Program," October 20, 1993, states that DoD organizations issued Economy Act orders to the Technology Brokering Program, circumventing the Federal procurement process; that DoD organizations did not provide for adequate contract administration and contract audits to verify that work was performed in accordance with the Tennessee Valley Authority cooperative agreements; and

Appendix B. Summary of Prior Audits and Other Reviews

that in FY 1992, the Tennessee Valley Authority earned about \$3.5 million in interest by requiring DoD to make payments before receiving goods and services.

The report recommends that the Deputy Under Secretary of Defense (Environmental Security) revise DoD Instruction 4000.19, "Interservice, Interdepartmental, and Interagency Support," to prevent misuse of Economy Act orders, obtain a refund of unliquidated advance payments, and transfer funds based on incurred costs. The Army, Navy, and Air Force generally agreed with the recommendation. The Deputy Under Secretary of Defense (Environmental Security) agreed to review DoD Instruction 4000.19 to include the recommended procedures and controls and reissued the Instruction in August 1995 with an effective date of October 1, 1995.

Congressional

United States Senate Report. The United States Senate, Subcommittee on Oversight of Government Management, Committee on Governmental Affairs, issued the report "Off-loading: The Abuse of Inter-Agency Contracting to Avoid Competition and Oversight Requirements," January 27, 1994. The report states that tens of millions of dollars annually have been wasted by Federal agencies through the use of "off-loads." An off-load is a contracting method used to avoid competition as in one Federal agency contracting for goods or services through another Federal agency. The Senate Subcommittee also found that some agencies charged fees as high as 20 percent to handle off-loaded contracts. While the fee is supposed to cover only the cost of executing the off-loaded contract, the Subcommittee found that some agencies charged more than their costs and made a profit from the fees. The profits become a slush fund for the agency, beyond the control of Congress or the Office of Management and Budget. The Senate Subcommittee recommended that the DoD address its extensive off-loading abuses. The Subcommittee required that DoD issue regulations limiting the circumstances under which off-loads are appropriate; requiring advance approval before any contract can be off-loaded; and banning excessive brokering fees. The Subcommittee also recommended that DoD develop a system to track off-loaded contracts, identify abuses, and take appropriate disciplinary action against officials who violate the new rules. As a result of the Senate Subcommittee report, the Secretary of Defense issued guidance on the use of orders under the Economy Act on February 8, 1994. In addition, FAR subpart 17.5, "Interagency Acquisitions Under the Economy Act," was updated to reflect the Subcommittee findings and recommendations.

Appendix C. Complaint to the Defense Hotline

Background. The Defense Hotline received a complaint concerning a Defense contractor using its influence to obtain work on a sole-source basis and about unallowable labor costs charged to DoD contracts. We were asked to determine whether the use of orders to other Navy organizations to award contracts on a sole-source basis was appropriate and whether labor costs were allowable.

Allegation. Work was improperly assigned to Battlespace on a sole-source basis, and Battlespace charged unallowable labor costs to DoD contracts.

Audit Results. The complaint could not be substantiated. We could not determine whether Battlespace improperly influenced the decision of the Unmanned Aerial Vehicles Program Manager to use orders with other Navy organizations to award sole-source contracts to Battlespace, nor could we determine that labor costs were unallowable. We determined that Battlespace was issued a high-risk mix of overlapping labor contracts and that the cognizant NAVAIR contracts division was unaware of the other Battlespace contracts issued by other Navy organizations through intra-agency contracting. We also identified questionable labor charges on the Battlespace contracts, as discussed in Part I.

Appendix D. Basis for Negotiated Battlespace Hourly Labor Rates on Time-and-Materials Contract N00019-94-D-0129

| Labor Category | Annual Salary | Annual Hours ¹ | Annual Hours Available Leave ² | Direct Costs | | Indirect Costs | | | | General and Administrative | |
|---|---------------|---------------------------|---|--------------|-------|-------------------------------|----------|---------|-------|----------------------------|-------|
| | | | | Percent | Hours | Bid and Proposal ³ | Overhead | Percent | Hours | Percent | Hours |
| Program Manager (President) | \$100,000 | 2,080 | 186 | 55 | 1,042 | 5 | 95 | 0 | 0 | 40 | 758 |
| Operational Systems Director/Engineer (Chairman of the Board) | 100,000 | 2,080 | 186 | 55 | 1,042 | 5 | 95 | 0 | 0 | 40 | 758 |
| Operational Systems Analyst | 77,500 | 2,080 | 186 | 59 | 1,117 | 0 | 0 | 41 | 777 | 0 | 0 |
| Test Engineer II | 77,500 | 2,080 | 186 | 59 | 1,117 | 0 | 0 | 41 | 777 | 0 | 0 |
| Junior Program Analyst | 30,000 | 2,080 | 186 | 70 | 1,326 | 2 | 40 | 17 | 330 | 11 | 199 |

¹Annual hours are based on 40-hour work week and 52-week year.

²Costs associated with annual leave hours are included in overhead costs. During contract negotiations, costs for annual leave hours were reduced from 220 hours to about 186 hours.

³Costs associated with bid and proposal costs are included in general and administrative costs.

Appendix E. Summary of Potential Benefits Resulting From Audit

| Recommendation Reference | Description of Benefit | Amount and Type of Benefit |
|-------------------------------------|---|---|
| 1. | Management Controls. Prevents a high-risk mix of overlapping labor contracts from being awarded to the same contractor. | Undeterminable. Amount depends on the types of contracts awarded. |
| 2.a. | Management Controls. Includes noncompetitive orders in reviews of intra-agency contracting. | Nonmonetary. |
| 2.b. | Economy and Efficiency. Establishes fair and reasonable labor rates on time-and-materials contracts. | Undeterminable. Amount depends on labor rates negotiated and hours expended. |

Appendix F. Organizations Visited or Contacted

Department of the Navy

Naval Air Systems Command, Arlington, VA
Naval Surface Warfare Center Dahlgren, VA
Fleet and Industrial Supply Center Charleston, SC

Other Defense Organizations

Defense Contract Audit Agency, Alexandria, VA
Mid-Atlantic Region, Alexandria Branch Office, Springfield, VA
Mid-Atlantic Region, Rosslyn Branch Office, Springfield, VA
Defense Logistics Agency, Alexandria, VA

Non-Government Organizations

Battlespace, Incorporated, Arlington, VA
ITT Defense and Electronics, McLean, VA

Appendix G. Report Distribution

Office of the Secretary of Defense

Under Secretary of Defense (Comptroller)
Deputy Chief Financial Officer
Deputy Comptroller (Program/Budget)
Director, Defense Procurement
Assistant to the Secretary of Defense (Public Affairs)
Director, Defense Logistics Studies Information Exchange

Department of the Army

Auditor General, Department of the Army

Department of the Navy

Assistant Secretary of the Navy (Financial Management and Comptroller)
Commander, Naval Air Systems Command
Program Executive Officer, Cruise Missiles Project and the Unmanned Aerial Vehicles
Joint Project
Auditor General, Department of the Navy

Department of the Air Force

Auditor General, Department of the Air Force

Other Defense Organizations

Director, Defense Contract Audit Agency
Director, Defense Logistics Agency
Director, National Security Agency
Inspector General, National Security Agency
Inspector General, Defense Intelligence Agency

Non-Defense Federal Organizations

Office of Management and Budget
Technical Information Center, National Security and International Affairs Division,
General Accounting Office
Office of Federal Procurement Policy

Non-Defense Federal Organizations (cont'd)

Chairman and ranking minority member of each of the following congressional committees and subcommittees:

Senate Committee on Appropriations
Senate Subcommittee on Defense, Committee on Appropriations
Senate Committee on Armed Services
Senate Committee on Governmental Affairs
House Committee on Appropriations
House Subcommittee on National Security, Committee on Appropriations
House Committee on Government Reform and Oversight
House Subcommittee on National Security, International Affairs, and Criminal
Justice, Committee on Government Reform and Oversight
House Committee on National Security

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Part III - Management Comments

Department of the Navy Comments



DEPARTMENT OF THE NAVY
OFFICE OF THE ASSISTANT SECRETARY
RESEARCH, DEVELOPMENT AND ACQUISITION
1000 NAVY PENTAGON
WASHINGTON DC 20350-1000

JUL 18 1996

MEMORANDUM FOR THE DEPARTMENT OF THE DEFENSE ASSISTANT INSPECTOR
GENERAL FOR AUDITING

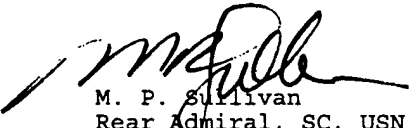
Subj: DODIG DRAFT REPORT ON "CONTRACTED SERVICES FOR THE MEDIUM
ALTITUDE ENDURANCE UNMANNED AERIAL VEHICLE JOINT PROJECT
OFFICE" (PROJECT NO. 6CF-8001)

Ref: (a) DODIG memo of 3 May 96

Encl: (1) Department of the Navy Response

This is in response to the draft audit report forwarded by
reference (a) concerning contracted services for the Medium
Altitude Endurance Unmanned Aerial Vehicle Joint Project Office.

The Department of the Navy response is provided at enclosure
(1). We concur with the draft report findings and have taken
action to improve contracting actions in the future.


M. P. Sullivan
Rear Admiral, SC, USN
Acting Principal Deputy

Copy to:
NAVJCSGEN
FMO-31
COMNAVAIRSYSCOM (AIR-8.0G)
COMNAVSUPSYSCOM (02)
COMNAVSEASYSYSCOM (02)

DEPARTMENT OF THE NAVY RESPONSE
TO
DODIG DRAFT REPORT OF 03 MAY 1996
ON
COMPLAINT TO THE DEFENSE HOTLINE ON CONTRACTED
SERVICES FOR THE MEDIUM ALTITUDE ENDURANCE
UNMANNED AERIAL VEHICLE JOINT PROJECT OFFICE
(PROJECT NO. 6CF-8001)

Finding: Intra-Agency Contracting by the Joint Project Office

The Joint Project Office for the Medium Altitude Endurance Unmanned Aerial Vehicle (UAV) used intra-agency contracting with other Navy activities to place sole-source orders greater than \$1 million, with Battlespace as a subcontractor, without appropriate reviews by the NAVAIR contract division. The intra-agency contracting orders were not reviewed by the cognizant NAVAIR contracts division because the Joint Project Office business manager did not follow a requirement to forward funding documents and sole-source justifications to the contracts division for review. As a result, Battlespace was awarded a high-risk mix of overlapping labor contracts (time-and-materials, firm-fixed-price, and cost-plus-fixed-fee), and Battlespace charged DoD contracts questionable labor costs totaling \$379,257 for calendar years 1993 and 1994.

Navy Comments: Concur. The NAVAIR contracts division was not informed beforehand of the specific contracting actions taken by other Navy contracting activities in support of the program office. The award of multiple contracts from different contracting offices to support the medium altitude endurance UAV occurred for the following reasons.

The training contract was awarded by the Fleet Industrial Support Office, Charleston because this activity had a contract in place which they agreed to modify to support the training requirements of the program office. It is not unusual to award a fixed price contract for discrete training products that could be anticipated. However, in this instance the negotiated fixed price exceeded the actual effort required to complete the work.

The Naval Surface Weapons Center, Dahlgren awarded a time and materials and a cost contract because Dahlgren was already involved in concept exploration with the UAV, and it was logical to have them continue the efforts.

NAVAIR awarded continuous time and materials, engineering and logistics support contracts, as is customary, to support the Joint Project Office requirements.

Recommendations:

1. We recommend that the Program Executive Officer, Cruise Missiles Project and the Unmanned Aerial Vehicles Joint Project, issue a policy memorandum to project offices and provide appropriate training to project office personnel relating to intra-agency contracting. The policy memorandum and training should emphasize the need to forward funding documents and sole-source justifications to the cognizant Naval Air Systems Command contracts division for orders issued through other Navy activities that ultimately result in sole-source contracts or orders greater than \$1 million.

Navy Comments: Concur. NAVAIR has policy on procedures for intra-agency funding. NAVAIR Instruction 7300.8C requires that the funding document and sole source justification for any intended non-competitive contract greater than \$1 million be forwarded to the cognizant NAVAIR contracts division for review prior to issuance by another Navy activity. Since orders are not specifically addressed in the instruction, we will issue a memorandum clarifying that orders are included within the meaning of "contracts" as it is used in NAVAIR Instruction 7300.8C. We will provide training on the requirements of NAVAIR Instruction 7300.8C to program office, contracting, business and financial personnel. This training will stress the importance and necessity of complying with NAVAIR policy instructions throughout NAVAIR.

2. We recommend that the Commander, Naval Air Systems Command:

a. Clarify the guidance on intra-agency contracting to ensure that "noncompetitive contracts" also includes noncompetitive orders on existing contracts.

Navy Comments: Concur. The guidance contained in NAVAIR Instruction 7300.8C on the use of intra-agency funding documents pertains to non-competitive orders placed under existing requirements contracts or basic ordering agreements. The memorandum, issued in response to Recommendation 1., will clarify this point.

b. Instruct the contracting officer for contract N00019-94-D-0129 to renegotiate fixed-hourly rates for Option Year II to a rate that reflects the actual hours worked under prior contracts.

Navy Comments: Concur. We cannot fully determine from information presented in the DODIG report whether a renegotiation of the fixed hourly rates is appropriate for Option Year II.

However, the contracting officer will review the rates and hours incurred during the first option year in order to determine whether an adjustment to the negotiated rates for the second option year is warranted, and make a determination in accordance with the Federal Acquisition Regulation before exercising the option. We anticipate completion by 31 August 1996.

Audit Team Members

This report was prepared by the Contract Management Directorate, Office of the Assistant Inspector General for Auditing, DoD.

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INTERNET DOCUMENT INFORMATION FORM

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Unmanned Aerial Vehicle Joint Project Office

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Symbol, & Ph #):** OAIG-AUD (ATTN: AFTS Audit Suggestions)
Inspector General, Department of Defense
400 Army Navy Drive (Room 801)
Arlington, VA 22202-2884

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DTIC-OCA, Initials: __VM__ Preparation Date 11/23/99

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